NATIONAL ENERGY MARKETERS ASSOCIATION

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May 17, 2002

Mr. Richard J. Williams
Director
Virginia State Corporation Commission
Division of Economics and Finance
Tyler Building
1300 E. Main Street
Richmond, VA 23219

Dear Mr. Williams:

The National Energy Marketers Association (NEM) hereby submits comments pursuant to your April 24, 2002, letter that posed questions related to the facilitation of effective competition in the state.

The National Energy Marketers Association (NEM) is a national, non-profit trade association representing wholesale and retail marketers of energy, telecom and financial-related products, services, information and related technologies throughout the United States, Canada and the U.K. NEM's Membership includes wholesale and retail suppliers of electricity and natural gas, independent power producers, suppliers of distributed generation, energy brokers, power traders, and electronic trading exchanges, advanced metering and load management firms, billing and information technology providers, credit, risk management and financial services firms, software developers, clean coal technology firms as well as energy-related telecom, broadband and internet companies.

This regionally diverse, broad-based coalition of energy and technology firms has come together under NEM's auspices to forge consensus and to help resolve as many issues as possible that would delay competition. NEM members urge lawmakers and regulators to implement:

- Laws and regulations that open markets for natural gas, electricity and related products, services, information and technology in a competitively neutral fashion;
- Rates, tariffs, taxes and operating procedures that unbundle competitive services from monopoly services and encourage true competition on the basis of price, quality of service and provision of value-added services;

- Competitively neutral standards of conduct that protect all market participants;
- Accounting and disclosure standards to promote the proper valuation of energy assets, equity securities and forward energy contracts, including derivatives; and
- Policies that encourage investments in new technologies, including the integration of energy, telecommunications and Internet services to lower the cost of energy and related services.

NEM offers the following responses and recommendations with respect to the questions set forth in your letter.

**1) What are the most significant obstacles to the development of a robust competitive retail electricity market for residential customers? For commercial and industrial customers? How can these obstacles be overcome?**

As will be discussed more fully in response to subsequent questions and in the attached articles, the most significant obstacles to the development of a robust competitive retail electric market are: 1) lack of accurate and timely price signals; 2) artificial price caps; and 3) the existing wires charge. These obstacles and their remedies are mentioned throughout NEM's responses. However, as a general matter, the solutions to these problems lie in the unbundling of utility rates based on the utilities' fully allocated embedded costs so that consumers can shop for all manner of competitive products, services, information and technology. Providing consumers with unbundled rates and/or shopping credits based on embedded costs is paramount to sending consumers accurate price signals and encouraging the development of the competitive market. Lifting price caps and allowing consumers to see and respond to changing prices for commodity is also critical. Finally, the removal, or at a minimum, a revision in the methodology for the calculation and assessment of the wires charge is also necessary for the development of the Virginia retail market.

**2) Last year, several parties that submitted recommendations on how to facilitate competition emphasized the importance of RTOs to the development of an efficient market. In particular, RTOs were seen as critical to resolving the issues of transmission constraints and market power. The establishment of RTOs is proceeding at a slower pace than many expected. Is it necessary for RTOs to be properly functioning before an effective competitive market is a possibility in the Commonwealth? How can Virginia assist competitive suppliers to enter the market in the absence of fully functional RTOs?**

NEM urges the Commission not to forestall further efforts to foster competitive retail markets pending RTO implementation. NEM asserts that ensuring a

properly functioning retail market will aid in the development of a properly functioning wholesale market. As discussed in the FTC Staff Report on Retail Competition,

> wholesale market demand at any given time is derived from retail customers' demand at that same time. Thus, it is important for states to adopt policies that will facilitate retail pricing that reflects real-time pricing that reflects wholesale price changes. As a result, there would be less need for the consideration of price caps on wholesale sales of electricity, because market participants will be able to adjust their consumption according to the prices for wholesale power. (FTC Staff Report on Retail Competition, issued September 2001, at page 34).

The FTC Report went on to explain that

> [p]rices are likely to be lower and reliability is likely to improve if more customers have time-sensitive rates and timely and accurate price information. With these things, customers can make better consumption and investment decisions that determine an efficient market equilibrium for electricity services. Increasing the price sensitivity of demand also will help to constrain existing or potential market power in generation. This is true because a price increase will be less profitable for generators if it is passed through and retail buyers respond by reducing their consumption by a significant amount. (FTC Staff Report on Retail Competition, issued September 2001, at page 41).

NEM urges the Commission to continue to work toward the development of a robust and competitive retail market, including providing consumers with access to pricing information and time-sensitive rates as a concurrent measure to complement FERC's standard market design rulemaking.

NEM also urges the Commission to exercise its authority and require the utilities to comply with Section 56-577(A)(1) and join a regional transmission entity as soon as practicable.

**3) FERC recently issued a paper titled, "Working Paper on Standardized Transmission Service and Wholesale Electric Market Design." In the paper FERC observed that it "must restructure electric transmission service to provide comparability for all sellers of electricity, use transmission assets more efficiently, and reduce inefficiencies by standardizing market rules. This should be done by creating a new, flexible transmission service to be offered by all transmission providers to all customers, with a new standard market design for wholesale electric markets." Is it necessary to have a functioning power exchange with policies and procedures that are consistent**

**with a standard market design in order to have effective competition in Virginia? If so, what are the essential elements of a standard market design?**

For the reasons noted in response to Question 2, NEM urges the Commission not to delay development of a robust competitive market pending completion of FERC's Standard Market Design.

NEM strongly supports FERC's initiative to implement a standard market design including many of the elements set forth in FERC's Working Paper. NEM supports the Working Paper proposals that provide pricing and scheduling flexibility, such as the broad definitions associated with "source" and "sink" to include, both individual nodes as well as aggregated points such as trading hubs. The requirement that transmission rights holders must sell unscheduled transmission rights is also important. NEM also supports the elements of the standard market design to include demand response measures, independent Market Monitoring Units, the use of modular software systems and both standardized data formats and transfer protocols. However, NEM opposes the proposed limits on bidding flexibility and bid caps.

**4) Are the Commission's Rules Governing Retail Access to Competitive Energy Services conducive to promoting effective competition in the Commonwealth? If not, how should they be modified? Is there any way in which these rules can or should be improved, in any event?**

NEM asserts that the Commission's Rules are generally conducive to promoting competition in the State. However, NEM submits that the Commission's Rules with respect to metering and billing should be revised. The Commission delayed implementation of competitive metering focusing instead only on access to interval meter data by customers or competitive service providers. Staff is required to file a report on competitive consolidated billing shortly.

NEM urges the Commission to expeditiously approve and implement competitive metering and consolidated billing rules. Competitive advanced metering enables suppliers to offer multiple pricing options, such as time of use rates, which increases the number of choices for customers and enables customers to save money by shifting usage to off-peak periods. If customers have hourly meters, they have the opportunity to see and respond to price spikes, which could enable price to bring supply and demand into balance. Advanced meters will also allow for increased accuracy and fairness of settlements in comparison with statistical load profiles.

Encouraging the development of a competitive market for billing services will allow competitive marketers to provide consumers with enhanced, value-added services. Suppliers should be able to present bills in order for consumers to have better access to innovative product offerings. It normally is not possible for Suppliers to provide many of these choices to consumers when the LDC presents

the bill. Without the option for suppliers to present bills to consumers, consumers are prevented from enjoying these innovative possibilities in product choice. Retail electricity customers overwhelmingly prefer single consolidated bills. Allowing only the utility to provide what customers want puts suppliers at an unfair competitive disadvantage. Billing is also an important point of contact for the supplier. It enables the supplier to promote and market its energy services. Inasmuch as consumers cannot choose their distribution company, billing simply does not serve the same function for the regulated utilities.

The Commission should develop unbundled rates or shopping credits for competitive metering and consolidated billing based on the utilities' fully allocated embedded costs (see response to Question 15 for further discussion embedded cost-based unbundled rates). Such action is consistent with the terms of Section 56-581.1 of the Code of Virginia which provides that the, "Commission shall adjust the rates for any noncompetitive services provided by a distributor so that such rates do not reflect costs associated with or properly allocable to the service made subject to competition. Such adjustment may be accomplished through unbundled rates, bill credits, the distributor's tariffs for licensed suppliers, or other methods as determined by the Commission."

**5) It has been suggested by one of Virginia's competitive suppliers that it is "unfortunate the state [Virginia] is buying advertising to educate citizens about electricity shopping where there isn't any market to speak of." (Restructuring Today, April 17, 2002). Is the SCC's Virginia Energy Choice consumer education program on target, or should it be scaled back until market activity picks up?**

Consumer education about customer choice is an invaluable component of implementing successful choice programs. Cutbacks in consumer education initiatives should not be undertaken lightly. NEM submits that upon implementation of the recommendations set forth in NEM's responses to foster market development, customer education initiatives must be redoubled to overcome customer inertia that may have developed due to lack of initial competitive offerings because of current market structure and conditions.

**6) What policies regarding aggregation and aggregators would promote the development of effectively competitive retail electricity markets in Virginia?**

NEM supports the proposition that market-based solutions such as aggregation can and should be utilized to promote the development of competitive markets. The ability of competitive suppliers to aggregate large groups of customers at low costs is critical to the attainment of economies of scale. In particular, aggregation programs would be useful to address the needs of low-income consumers and to allow low-income consumers access to lower prices in the most efficient way possible.

NEM urges that if the Commission adopts an aggregation program, such as the one implemented in Ohio and referenced in Question 14(a), it must ensure that the program does not limit consumer choice. In other words, it is critical that consumers be provided adequate notice and the opportunity to "opt out" of an aggregation program and procure energy supply and services from alternative competitive means.

**7) Upon shopping customers return to capped rate service provided by local distribution companies, should these returning customers have the option of paying a "market-based" price (or other alternative pricing option) instead of capped rates as a means of avoiding any applicable minimum stay requirements?**

As a general matter, NEM asserts that minimum stay requirements unnecessarily restrict customers from exercising the option to choose another supplier and should not be adopted. NEM notes that this Commission limited its minimum stay requirement to customers whose annual peak demand is at least 500 kW. The Commission imposed this requirement "with reluctance" stating it would, "prefer to allow all customers unfettered access to their choice of electricity suppliers so as to encourage the creation of a competitive market void of artificial constraints inhibiting economically rational behavior." (Case PUE010296, issued October 9, 2001, at page 9). NEM submits that there has been no change in circumstances to warrant an expansion of the minimum stay requirement to additional consumer classes.

**8) Some potential competitors have suggested that the projected market prices for generation developed by the Commission in establishing wires charges under § 56-583 should reflect a retail market price rather than a regional wholesale market price. Please comment on this.**

The pricing of default service is critically important to the development of a new competitive market because the default service price serves as the "price to compare" – the target against which all competitive offers are judged by consumers. Default service must be priced at retail rates for each customer class. If the default service price is subsidized or set artificially low, i.e., if it does not reflect the true costs of providing retail generation service, true competition on the basis of price and quality of service will not be possible. Competitive suppliers will be challenged to cover their costs and offer products that provide value to customers. If the incumbent utility acting as the default service supplier is permitted to subsidize retail energy services by passing through wholesale price signals and embedding the retail costs of energy-related services in its distribution rate, a competitive marketplace cannot occur. Indeed, permitting utilities to maintain default service and offer false price signals in the process not only distorts energy price signals, but establishes a significant barrier to effective price competition by forcing customers who switch to competitive suppliers to pay

twice for retail energy services. Under these circumstances fewer customers will choose competitive energy service providers, the utility's market share will be maintained, consumers will not benefit to the degree they should, and competitive markets simply won't develop.

Default pricing for electricity should include transmission charges, scheduling and control area services, and distribution system line losses, a share of pool operating expenses, risk management premiums, load shape costs, commodity acquisition and portfolio management, working capital, taxes, administrative and general expenses, the costs of metering, billing, collections, bad debt, information exchange, compliance with consumer protection regulations, and customer care.

**9) In a recent Richmond Times Dispatch article concerning retail choice and the absence of measurable competitor activity in service territories currently open to retail choice, competitive suppliers reportedly identified wires charges as a significant barrier to competitive entry in the Virginia generation market. Please comment on that assertion.**

NEM agrees that the wires charge is a significant barrier to entry in the Virginia market. The manner in which the wires charge is calculated and implemented makes it virtually impossible for competitive suppliers to compete with the utilities.

While recognizing that stranded cost recovery is a valid concern for the utilities, NEM urges that a competitively neutral means of collecting stranded costs should be instituted. NEM recommends that any costs that are unavoidable because utilities must incur such costs to perform Provider of Last Related (POLR)-related services should be recovered through adjustments to the rates charged for POLR-related services. Any costs or lost revenues not connected with the utilities' provision of POLR-related services and fully bundled sales service should be added to distribution rates in a competitively neutral fashion.

**10) Last year in its response to Commission Staff inquiries about facilitating effective competition, Allegheny Power recommended a concept it titled "The Fund." This would be a mechanism whereby rate caps could be incrementally increased to facilitate market development, thus creating "head room" for competitive offers. To the extent that an incumbent utility received revenues in excess of its rate cap, a fund would be established that could be used to reduce potential post-transition rate shock, subsidize demand response programs, and/or subsidize public benefit programs. Please comment on this suggestion.**

See response to Question 11 below.

**11) LG&E Energy suggested last year in its response to Commission Staff inquiries about facilitating energy competition that there should be no price caps. Please comment on this suggestion.**

Price caps do not facilitate energy competition and do not permit consumers to modify their consumption levels in response to price. Utility pricing mechanisms must be flexible enough to accommodate and reflect changes in price in the wholesale market. NEM is cognizant of the concern that consumers should be protected from erratic price swings. However, if consumers were permitted to see and respond to real-time pricing signals they could adjust their consumption thereby lessening the impact of price spikes. For example, the FTC Staff explained in their Retail Competition Report that

> It does not necessarily follow, however, that exposing consumers to variable prices and real-time metering is necessarily incompatible with stable customer bills. With variable real-time retail pricing that reflects underlying real-time wholesale prices, retail prices sometimes will be higher than the average price and sometimes will be lower. The aggregate bill rendered under variable pricing could be higher, lower, or the same as the bill for the same individual customers under average pricing. A customer's bill will tend to be lower to the extent that the customer consumes less electricity than average when the real-time price is high. And some customers may be able to both consume more total power and pay less in total when they shift consumption from high price hours to low price hours. (FTC Staff Report on Retail Competition, issued September 2001, at page 37).

Accordingly, NEM would argue that the more appropriate consumer protection concern is empowering consumers to engage in demand response through variable pricing and access to real-time pricing signals. Price caps are simply incompatible with fostering demand response.

FERC has also indicated its commitment to fostering demand response initiatives in its standard market design. If retail markets are incapable of producing a demand response, due in part to capped rates, this will thwart FERC's valuable objective.

**12) Is there a role for regulation in the promotion of demand-side participation, whereby customers are provided the means to receive price signals and adjust their demand during high-cost periods.**

The role for regulation in the promotion of demand-side participation lies in the creation of a market whereby consumers are able to see and respond to real-time price signals. This entails creating a standard offer service that reflects the full energy supply and commercial costs of serving no-notice customers and that

incorporates changes in wholesale prices. When energy prices rise, consumers on standard offer service will be incented to conserve energy and/or choose a lower cost competitive alternative.

Furthermore, the Commission can play a role in demand response by making metering competitive and providing consumers with access to advanced real-time meters and other technology that will help them modulate their energy usage in response to price.

The Commission can also encourage demand response through the facilitation of the use of distributed generation technology. Distributed generation can provide real value as a demand-side management resource as it reduces customer impacts on the distribution system and enhances system reliability. NEM urges the Commission to unbundle and redesign distribution rates, eliminate penalties, redundant charges, and barriers to entry for distributed generation and implement tariffs that encourage investments in this technology. The Commission should also adopt a uniform interconnection standard in order to reduce the cost to install distributed generation.

**13) Virginia's electric cooperatives are exempted by statute from certain Restructuring Act provisions. For example, (i) cooperatives are not required to provide CSP consolidated billing (§ 56-581.1 J of the Restructuring Act); (ii) default service in cooperatives' service territories cannot, as a matter of course, be put out to competitive bid (§ 56-585 F of the Restructuring Act); and (iii) Virginia's electric cooperatives are permitted under § 56-231.34:1 of the cooperative act to make direct, unregulated sales of electric power within their service territories without having to form affiliates to do so (this would appear to permit cooperatives to selectively discount generation prices on a customer-by-customer basis). In light of these exemptions, how should competitor entry into cooperatives' service territories be encouraged and facilitated?**

**14) Several states have enacted or are considering incentives to foster competitive activity. Please comment on the following:**

> **a. There is a legislative proposal pending in Rhode Island to give cities and towns the ability to shop for their residents. Under this proposal, residents would automatically be switched to a locality's choice of electricity supplier unless they "opted out" in order to stay with their incumbent utility. This proposal is similar to provisions in Ohio law authorizing local governments to aggregate their residents on an "opt out" basis if approved by a majority vote of those residents on a general or primary election ballot. Locality aggregation in Ohio is subject to certain provisions, however, including the right of residents to "opt out" every two years without paying a switching fee.**

See the discussion in response to question 6.

**b. The Maine Public Utility Commission recently conducted an auction to determine its "standard offer," i.e., generation service roughly equivalent of "default service" in most states. It requested proposals to procure power on behalf of ratepayers for one year, hoping that eventually the market will become fluid enough so that individuals would shop on their own.**

NEM submits that it will be difficult for a competitive market to flourish as long as the incumbent utility retains the merchant function. NEM submits that if a competitive bid process is properly structured so that competitive provision of standard offer service is possible based not only on the wholesale price of commodity, but on all of the energy supply and commercial costs of rendering the service (see response to Question 8), than a truly competitive electricity market will be encouraged.

NEM also urges that the bid process be designed for selection of suppliers to directly serve retail customers as opposed to the competitive selection for wholesale contracts to meet the needs of retail customers. Implementation of a bid system for wholesale contracts to will not contribute to the ultimate development of a competitive retail market because customers will be unaware of the competitive suppliers serving their supply needs. The competitive suppliers will have no direct conduit with customers and will not be able to establish themselves in customers' perception of reliable, low cost suppliers. Customers will not be receiving standard offer service on a truly competitive basis because the utility will still be acting as an intermediary point of contact for supply. Competitive suppliers must be able to render standard offer service at the retail level.

**c. Under an agreement with the Public Utility Commission of Ohio ("PUCO"), First Energy (an Ohio incumbent electric utility) agreed to make available 1,120 MW of "Market Support Generation" to non-affiliated marketers, brokers and aggregators for sale to retail customers during a "market development period" that followed Ohio's introduction of retail competition. The capacity was made available on a first-come, first-served basis at prices set through negotiations with the PUCO staff and based on generation cost and wholesale market prices.**

With respect to Ohio's market support generation program, NEM asserts that such a program may have value as a limited transition mechanism. However, NEM directs this Commission to the conclusions reached by the FTC Staff in its recent report on retail competition. The FTC Staff concluded that,

> "requiring incumbent utilities to provide generation capacity to retail suppliers at prices that reflect the value of generation assets as determined administratively when assessing the level of the

> utility's stranded costs, may mask whether the underlying market is conducive to support retail competition. As a transition mechanism while stranded costs are being recovered, however, these programs may allow entrants to start serving customers while they make longer-term supply arrangements." (FTC Staff Report on Retail Competition, issued September 2001, at pages 61-62).

Accordingly, this Commission may want to utilize such a program in conjunction with other measures to ensure the creation of a viable competitive market. NEM also notes that there have been implementation disputes associated with the program in Ohio. If such a program were to be implemented in Virginia it must be done on an open, non-discriminatory basis.

**15) Are there any other actions that have been taken or are being considered in other states that may be used to advance competitive entry in Virginia?**

The NYPSC has instituted a proceeding in which the utilities are required to implement unbundled, embedded cost-based rates. The NYPSC has, "concluded that a prerequisite to fostering retail market development is the establishment of unbundled rates for competitive or potentially competitive functions that reflect fully allocated costs." (Case 00-M-0504, Order issued November 9, 2001, at page 1.) Accordingly, the electric utilities were required to submit embedded cost of service studies and rates that separate costs for supply, supply-non-bypassable, delivery, meter service providers, meter data service providers, meter ownership, billing and payment processing, competitive energy services, customer care and uncollectibles. (See Attachment A to Commission's November 9, 2001, Order).

The Illinois Commerce Commission has also repeatedly affirmed its commitment to base delivery service, metering and billing credits on embedded costs. The Commission stated in Commonwealth Edison's delivery services proceeding that, "[t]he use of embedded costs has been applied uniformly by this Commission to all DST providers in Illinois. . . . We also again find that the embedded cost approach advances concerns of economic efficiency as well as sending economically-correct price signals that are pivotal to the proper development of the market." (Case 01-0423, Order issued April 1, 2002, at page 124).

Embedded cost-based unbundled rates serve an important function in providing consumers with a "price to beat" for competitive services. Consumers should be able to compare competitive service offerings for a range of competitive products, services, information and technologies on a line item basis with utility charges. Embedded cost-based unbundling provides an important educational function to consumers.

The proper prices to beat for contestable services are the utilities' embedded costs. Embedded costs are the basis for rates which consumers currently and historically have been charged. Utility revenue requirements are established based on fully allocated embedded costs, and accordingly, such costs have already been determined by the Commission to be "just and reasonable." Implementing unbundled rates or shopping credits based on less than the just and reasonable rates that consumers are currently being charged for products and services that are available from competitive sources is inherently unjust and unreasonable.

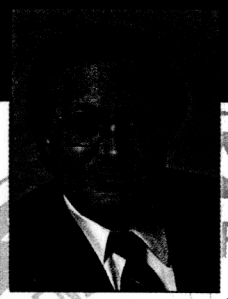
Unbundled rates based on the same just and reasonable rates currently paid by consumers will also help to establish efficient competitive markets for contestable services. As long as utilities collect marginal revenues based on embedded costs (that are presumably just and reasonable), then the most economically efficient, just and reasonable unbundled rates should also be based on the same embedded costs. This will be true until the utility no longer offers contestable services and competition to provide these services at or below current utility prices permits a truly competitive price for these services to equalize at the point where marginal revenues paid for these services equal the marginal costs to produce them by competitive non-regulated, non-subsidized vendors. As a result, marginal utility revenues received by adding a new customer will and should be exactly equal to the marginal utility costs of losing an existing customer, while at the same time providing an unbundled price to beat that the Commission has already determined to be "just and reasonable."

If customers pay less than fully embedded costs for competitive services, customers will be paying an artificially low, subsidized rate for services that can be rendered by competitive sources. Additionally, if utilities' unbundled rates reflect and their customers pay less than fully embedded costs, customers served in the competitive market end up paying twice for these services. In conjunction, these two effects will slow customer migration to the market and the utilities will continue to incur costs for competitive services that may ultimately become stranded. Without embedded cost-based unbundled rates/backout charges, customers will not realize the full benefits of a vibrant competitive market.

NEM appreciates this opportunity to comment on the facilitation of effective retail electric competition in Virginia and reiterates our commitment to working with the Commission and the other stakeholders to devise fair and effective ways to implement competitive restructuring in the state.

Sincerely

Craig G. Goodman, Esq.
President
National Energy Marketers Association



By Craig G. Goodman, President/CEO, National Energy Marketers Association, Washington, DC

# Restructuring Issues For 2002

The past year has brought profound changes in both the debate and implementation of U.S. energy restructuring. 2001 brought a new president, a new FERC, a new type of war, a collapse in the technology and telecom sectors as well as the collapse of an energy industry giant, new types of utility ratemaking proceedings and new energy technologies. All of which will have a profound influence on the shape of U.S. energy restructuring in 2002.

FERC has issued a series of Orders aimed at making U.S. wholesale markets for electricity more liquid, transparent and competitively neutral. If successful, wholesale energy marketers and markets will be able to accurately price and value electricity into the future with far more certainty than exists today. Over-the-counter electricity trading will become more liquid and ultimately move toward more formalized futures contracts similar to those in other markets.

State PUCs in several key states will initiate the unbundling of rates for competitive energy supplies and related products, services, information and technology from the rates for transmission and distribution. If successful, retail marketers and consumers will get accurate price signals based upon the prices consumers are currently paying for these services within bundled embedded-cost-of-service based rates. If PUCs fail to provide consumers with shopping credits based on the fully embedded costs that the commissions have previously declared to be "just and reasonable," then the retail consumer will be short-changed, and the prices-to-beat for competitive energy supplies and services will be less, perhaps far less, than either "just or reasonable."

**Federal Wholesale Trading and Marketing Issues:** In 2002, FERC, DOE, North American Energy Standards Board (NAESB), NERC, FTC, FCC, SEC, CFTC, FASB and Congress will be actively engaged in passing laws or rules that will significantly reshape the U.S. energy industry in 2002. Federal issues will involve the restructuring of wholesale markets, trading and risk management, wholesale standards at NERC/NAESB, development and implementation of RTOs, the definition and application of market power and economic withholding with associated refund liability, the proper standards of conduct for affiliated entities, incentives for load shifting, standardized interconnections, demand side management, liquidity and tradability of transmission rights as well as rules concerning the valuation of trading portfolios and risk management.

Congress will likely pass federal restructuring legislation granting FERC the powers it needs to complete the RTO process, site interstate transmission and move to a more liquid, seamless, transparent and competitively neutral wholesale energy market. Legislation will also likely have incentives for advanced metering and distributed generation.

**Retail Issues:** Numerous states will be developing unbundled rates for distribution, transmission and competitive products and services in 2002. To their credit, Michigan, Illinois and New York have endorsed an embedded cost-based unbundled rate design that could substantially increase marketer opportunities and meaningful price competition for consumers in these states. NEM strongly supports these efforts. However, utilities are strongly resisting the new unbundled rate designs and are rearguing the need for marginal or decremental "avoidable cost" based rate design instead. If the utilities effectively reverse these commission policies, the costs to consumers will skyrocket, the number of migrating customers will slow considerably, the total stranded costs and the time necessary for marketers to achieve economies of scale and lower acquisition costs will also increase significantly.

Simultaneously, utilities are proposing less than embedded cost-based POLR rates and multi-year fixed price offerings while attempting to hide and recover any lost revenues plus hedging costs and other competitive service related costs in delivery rates for all consumers. If utilities are successful in shifting these costs, the ability to offer consumers real price competition will be slowed considerably.

A number of time-worn, anti-competitive utility regulatory positions continue to be proposed, including onerous supplier fees, switching fees, imbalance and storage fees, delivery penalties, stand-by rates and demand charges, interconnection fees, firm pipeline capacity requirements, and the over-commitment of generation during summer peak months. In my opinion, regulatory commissions are starting to understand the negative impact of these proposals, and NEM will be called upon increasingly to file in opposition to these onerous fees and penalties.

**Technology Issues and Industry Standards Development:** A number of technology-related issues will be addressed by either NAESB, NERC or by a FERC-mandated organization if industry consensus cannot be found by March 2002. Standards for data and information exchange, metering, billing and internet protocols will likely be addressed within this structure. NEM is on the NAESB Advisory Committee for 2002 and relies upon the technical expertise of its members to assist in the development of these standards. Additionally, distributed generation and advanced metering are being targeted in Congress for incentives. The industry will also likely need additional bandwidth from the FCC for a number of important information needs. Nationwide, considerable work needs to be done on stand-by rate design for self-generation, as well as standardized interconnections and environmental permitting requirements before distributed generation can become the "cell phone" of a competitive energy industry.

We urge your support for open, liquid and competitive wholesale and retail markets for energy and related products, services, information and technology and meaningful price competition for consumers at the earliest possible time. Please contact NEM headquarters at 202-333-3288 or visit our website at www.energymarketers.com or e-mail us at cgoodman@energymarketers.com if you would like to join the efforts to open U.S. energy markets to competition.

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# Standard Competitive Market Designs

The Supreme Court has recently decided that FERC has all the authority and discretion it needs to implement restructuring at the national level with impacts all the way down to the bundled retail transmission customer. This case will likely have a significant impact on all future FERC rulemakings, particularly proposals to implement a Standard Wholesale Market Design.

Given this significant change in the regulatory landscape, it is now more important than ever that state regulators design retail markets to remove barriers to competition and provide consumers with accurate price signals.

### A. Fully Allocated Embedded Cost-Based Unbundled Rates Are The Foundation For A Competitive Retail Market Design

The proper prices to beat for competitive services are the utilities' fully allocated embedded costs. Embedded costs are the basis for rates which consumers currently and historically have been charged by utilities for fully bundled services. Utility revenue requirements are established based on fully allocated embedded costs, and accordingly, such costs have already been determined by state commissions to be "just and reasonable." Implementing unbundled rates or backout credits for competitive products, services, information and technologies based on less than the just and reasonable rates that consumers are currently being charged is inherently unjust and unreasonable.

If unbundled rates are based on the same just and reasonable rates currently paid by consumers, it will help to establish efficient competitive market prices for contestable services. This will be true until the utility no longer offers such services and competition to provide these services at or below current utility prices and permits a truly competitive price for these services to equalize at the point where marginal revenues paid for these services, in fact, equal the marginal costs to produce them by competitive non-regulated, non-subsidized vendors. As a result, marginal utility revenues received by adding a new customer will and should be exactly equal to the marginal utility costs of losing an existing customer.

### B. Unbundled Rates Based On Incremental Costs Undermine A Competitive Market Structure

Incremental/marginal/avoided cost methodologies should not form the basis of unbundled rates. Unbundled rates based on incremental costs or decremental savings will not accurately reflect the true prices that consumers actually pay for competitive services currently provided by utilities and will therefore fail to provide consumers with adequate price information to compare utility rates and competitive offers. Furthermore, the implementation of unbundled rates that are less than the bundled rates that consumers are currently paying for competitive services will, by definition, result in unbundled rates that are less than just and less than reasonable. In addition, properly quantifying incremental costs requires extensive speculation about future migration rates, the timing of migration, the "best available technology" in the marketplace, and the competitive cost of capital.

Furthermore, the methodology for unbundling telecommunication network elements is not an appropriate manner to unbundle competitive energy products, services, information and technologies currently bundled in utility network sales that are available elsewhere from competitive vendors.

### C. Proper Structuring Of Stranded Cost Recovery Is Essential To Competitive Market Design

"Just and reasonable unbundled utility rates" based on fully embedded costs will allow utilities to both quantify and, if properly mitigated, recover stranded costs within a reasonable time frame without incurring and imposing new costs on departing customers. Stranded costs or revenues lost due to migration should be calculated after unbundled rates or shopping credits based on fully embedded costs have been implemented and actual migration has occurred.

Once a reasonable time has elapsed during which consumers are able to shop for one or more competitive services with embedded cost-based credits, then a calculation of the difference between the revenues that the utility would have received using fully embedded cost-based rates and the revenues actually received by the utility can be made.

Utility recovery should be premised upon a utility showing that: (1) the costs are material; (2) the costs were productively managed and reasonably mitigated; (3) the utility is not earning in excess of its earnings/sharing cap; and (4) the utility's stranded costs or lost revenue was not a result of the utility's POLR obligation or the need to provide fully bundled service. Any costs or lost revenues connected with POLR-related services or fully bundled sales service should be recovered in those rates. Remaining costs that are truly stranded should be recovered in a competitively neutral fashion.

### D. Conclusion

The goals of deregulation are to lower costs, improve the quality of service and provide value-added services to consumers. These goals are attainable if the state implements uniform, consistent standards, processes, contract terms, and information protocols that allow competitive suppliers to effectively compete in multiple utility service territories and jurisdictions at the lowest cost to consumers.

NEM urges regulators and legislators to require utilities to exit the merchant function by a date certain and to implement fully allocated embedded cost-based unbundled rates at the earliest possible time. NEM submits that embedded cost-based rates for competitive services previously bundled is just and reasonable, and that consumers deserve no less than just and reasonable unbundled rates.